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In the Supreme Court of the United States

LEE M. TILL AND AMY M. TILL, PETITIONERS,

v.

SCS CREDIT CORPORATION

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION PRESENTED

Under the "cram down" provision of Chapter 13 of the Bankruptcy Code, if the holder of a secured claim objects to a proposed repayment plan under which the debtor retains the collateral securing the claim, the plan may be confirmed only if, *inter alia*, it preserves the secured creditor's lien and provides sufficient payments to the creditor over the period of repayment so that the present value of the payments is "not less than the allowed amount of [the secured] claim." 11 U.S.C. 1325(a)(5)(B)(ii). The question presented is:

How should a court determine the discount rate in assessing the present value of plan payments under 11 U.S.C. 1325(a)(5)(B)(ii)?

TABLE OF CONTENTS

	Page
Interest of the United States	1
Statement	2
Summary of argument	7
Argument:	
The appropriate discount rate in assessing the value of payments under a plan should primarily reflect the time value of money, not the particular creditors' profits under pre-bankruptcy contracts	10
A. The court of appeals' contract-rate approach is inconsistent with the text and purposes of Section 1325(a)(5), especially as interpreted by this court in *Rash*	13
B. The prime-plus formula approach, unlike the con tract-rate approach, comports with the Bank-ruptcy Code's fundamental goal of treating similar classes of creditors equally	19
C. The court of appeals' reasons for rejecting the prime-plus formula are unpersuasive	25
Conclusion	29

TABLE OF AUTHORITIES

Cases:	
American Iron & Steel Mfg. Co. v. *Seaboard Air Line Ry.*, 233 U.S. 261 (1914)	22
Associates Commercial Corp. v. *Rash*, 520 U.S. 953 (1997)	*passim*
Atlantic Mutual Ins. Co. v. *Commissioner*, 523 U.S. 382 (1998)	3
Begier v. *IRS*, 496 U.S. 53 (1990)	19
Bruning v. *United States*, 376 U.S. 358 (1964)	22
Chesapeake & Ohio Ry. v. *Kelly*, 241 U.S. 485 (1916)	11

Cases—Continued: Page

Computer Optics, Inc., In re, 126 B.R. 664 (Bankr. D.N.H. 1991) 16
Dunn v. *CFTC*, 519 U.S. 465 (1997) 21
GMAC v. *Jones*, 999 F.2d 63 (3d Cir. 1993) 16, 17, 20, 21
Ivey, In re, 147 B.R. 109 (M.D.N.C. 1992) 16
Jones & Laughlin Steel Corp. v. *Pfeifer*, 462 U.S. 523 (1983) 12, 26
Jordan, In re, 130 B.R. 185 (Bankr. D.N.J. 1991) 16
Kidd, In re, 315 F.3d 671 (6th Cir. 2003) 24
Koopmans v. *Farm Credit Servs. of Mid-America, ACA*, 102 F.3d 874 (7th Cir. 1996) 23
Nicholas v. *United States*, 384 U.S. 678 (1966) 22
Rash, In re, 31 F.3d 325 (5th Cir. 1994) 11
Smithwick, In re, 121 F.3d 211 (5th Cir. 1997), cert. denied, 523 U.S. 1074 (1998) 17
Union Bank v. *Wolas*, 502 U.S. 151 (1991) 19
United Carolina Bank v. *Hall*, 993 F.2d 1126 (4th Cir. 1993) 17, 19

Statutes:

Bankruptcy Code, 11 U.S.C. 101 *et seq.*:
Ch. 1, 11 U.S.C. 101 *et seq.*:
11 U.S.C. 104(b) 2
Ch. 3, 11 U.S.C. 301 *et seq.*:
11 U.S.C. 361(3) 18
Ch. 5, 11 U.S.C. 501 *et seq.*:
11 U.S.C. 502 21
11 U.S.C. 502(b) 20, 21
11 U.S.C. 502(b)(2) 20, 21
11 U.S.C. 506(a) 14, 15
Ch. 7, 11 U.S.C. 701 *et seq.* 2, 9, 20, 25
Ch. 11, 11 U.S.C. 1101 *et seq.* 1, 4, 11, 18, 20, 21
11 U.S.C. 1129(a)(7) 4
11 U.S.C. 1129(a)(7)(A)(ii) 20
11 U.S.C. 1129(a)(9)(B)(i) 4
11 U.S.C. 1129(a)(9)(C) 4

Statutes—Continued: Page

11 U.S.C. 1129(b)(2)(A)(i) 18
11 U.S.C. 1129(b)(2)(A)(iii) 18
11 U.S.C. 1129(b)(2)(A)(i)(II) 4
11 U.S.C. 1129(b)(2)(B)(i) 4
11 U.S.C. 1129(b)(2)(C)(i) 4
Ch. 12, 11 U.S.C. 1201 *et seq.* 1, 4, 20
11 U.S.C. 1225(a)(4) 4, 20
11 U.S.C. 1225(a)(5)(B)(ii) 4
11 U.S.C. 1225(b)(1)(A) 4
11 U.S.C. 1228(b)(2) 4
Ch. 13, 11 U.S.C. 1301 *et seq.* ..... *passim*
11 U.S.C. 1302 ..... 10, 27, 28
11 U.S.C. 1305(c) 10, 27
11 U.S.C. 1322 13
11 U.S.C. 1322(b)(2) 13, 14
11 U.S.C. 1322(c)(2) 13
11 U.S.C. 1325 ..... 2, 11, 16, 17, 20
11 U.S.C. 1325(a)(4) 4, 11, 20
11 U.S.C. 1325(a)(5) ..... *passim*
11 U.S.C. 1325(a)(5)(B)(ii) 1, 3, 4, 7, 10, 14
11 U.S.C. 1325(a)(5)(C) 3
11 U.S.C. 1325(a)(6) 2, 10, 11, 12, 21, 26, 27, 28
11 U.S.C. 1325(b)(1)(A) 4
11 U.S.C. 1325(c) 2, 10, 27
11 U.S.C. 1326(a)(2) 10, 27, 28
11 U.S.C. 1328(b)(2) 4

Miscellaneous:

Keith M. Lundin, *Chapter 13 Bankrputcy* (3d ed. 2002):
Vol. 1 13
Vol. 2 20
8 *Collier on Bankruptcy* (Alan N. Resnick & Henry J. Sommer, eds., 15th ed. rev. 2003) 20, 23, 27
H.R. 4786, 97th Cong., 1st Sess. (1981) 14
H.R. 1085, 98th Cong., 1st Sess. (1983) 14

Miscellaneous—Continued: Page

H.R. 1169, 98th Cong., 1st Sess. (1983) 14
H.R. Rep. No. 595, 95th Cong., 1st Sess. (1977) 3, 4, 11, 21, 25

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INTEREST OF THE UNITED STATES

This case concerns whether, when a bankruptcy plan schedules payments to a secured creditor and those payments must be discounted to present value under 11 U.S.C. 1325(a)(5)(B)(ii), the discount rate should be presumptively equal to the debtor's pre-bankruptcy contract rate. That issue is of substantial importance to the United States because it potentially affects the treatment of all secured creditors under Chapters 11, 12, and 13 of the Bankruptcy Code. The United States appears in thousands of bankruptcy proceedings each year, and a number of federal agencies—including the Department of Housing and Urban Development, the

Commerce Department's Economic Development Administration, the Small Business Administration, the Internal Revenue Service, and the Federal Deposit Insurance Corporation—appear as creditors in proceedings analogous to the case at hand. Because a bankruptcy estate's assets are typically scarce, the United States' rights are often affected by demands from secured creditors for payment based on inordinately high pre-bankruptcy contract rates.

STATEMENT

1. Chapter 13 of the Bankruptcy Code allows individuals with a regular income to adjust their debts through a repayment plan if they have less than $269,250 in unsecured debts and less than $807,750 in secured debts. See 11 U.S.C. 104(b) & note, 109(e). Repayment plans under Chapter 13 often present a workable alternative to Chapter 7 bankruptcy, which requires liquidation of all non-exempt assets. Chapter 13 plans must be judicially confirmed in order to have legal effect, and standards for confirmation are set forth in 11 U.S.C. 1325. Section 1325 requires courts to verify, *inter alia*, that "the debtor will be able to make all payments under the plan and to comply with the plan," 11 U.S.C. 1325(a)(6), and if a debtor fails to make payments as prescribed by the plan, the court may take a number of remedial steps, including ordering payments directly from the debtor's income, 11 U.S.C. 1325(c).

Section 1325(a)(5) provides that if a secured creditor objects to a repayment plan that provides for the debtor to retain the collateral securing the claim, the repayment plan cannot be confirmed unless it preserves the secured creditor's lien and provides that "the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is

not less than the allowed amount of such claim." 11 U.S.C. 1325(a)(5)(B)(ii).[1] Under that provision, bankruptcy courts must calculate the present value of the stream of future payments provided for by the plan to ensure that the present value of those payments, *i.e.*, the "property * * * distributed under the plan," is not less than the value of the creditor's secured claim. *Ibid.* In *Associates Commercial Corp.* v. *Rash*, 520 U.S. 953, 957 (1997), this Court made clear that in a case, like this, where the debtor retains the collateral, the value of the secured claim, *i.e.*, the "allowed amount of such claim," is determined by the value of the collateral as retained by the debtor, not its foreclosure value to the creditor. The Court also explained that Section 1325(a)(5) requires the debtor "to provide the creditor with payments, over the life of the plan, that will total the present value of the allowed secured claim, *i.e.*, the present value of the collateral." 520 U.S. at 957. Such present value calculations require courts to use a "discount rate" that approximates the effect of inflation and the time value of money. H.R. Rep. No. 595, 95th Cong., 1st Sess. 414 (1977); cf. *Atlantic Mutual Ins. Co.* v. *Commissioner*, 523 U.S. 382, 384 (1998) (explaining that "[a] dollar today is worth more than a dollar tomorrow") (internal quotation marks and citation omitted). The Code does not specify what "discount rate" should be used by the bankruptcy court in ensuring that the present value of the stream of payments provided for in the plan is not less than the value of the collateral.

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[1] A Chapter 13 plan can also be confirmed if the secured creditor accepts the plan, see 11 U.S.C. 1325(a)(5)(A), or if the debtor surrenders the property securing the claim to the creditor, see 11 U.S.C. 1325(a)(5)(C). See generally *Associates Commercial Corp.* v. *Rash*, 520 U.S. 953, 956-957 (1997).

Because Section 1325(a)(5) provides that secured creditors must accept future payments under the plan and may not demand immediate possession of the collateral, it is commonly referred to as a "cram down" provision. See *Rash*, 520 U.S. at 957. Similar provisions appear in Chapter 11, which concerns bankruptcy reorganization plans, and Chapter 12, which concerns debt adjustment for family farmers. See 11 U.S.C. 1129(b)(2)(A)(i)(II) and 1225(a)(5)(B)(ii). Identical or similar language regarding present value appears in the Bankruptcy Code in a number of analogous contexts. See H.R. Rep. No. 595, *supra*, at 408.[2]

2. In October 1999, petitioners Lee and Amy Till filed for bankruptcy protection, and they eventually proposed a three-year repayment plan under Chapter 13. One of petitioners' creditors, respondent SCS Credit Corporation, has a $4000 allowed secured claim that is secured by petitioners' vehicle and derives from a loan agreement dated October 1998. Pet. 3. Respondent objected to the repayment plan on the ground that its payments, when discounted to present value, were less than $4000 and thus violated Section 1325(a)(5)(B)(ii). Pet. App. 4a-5a. The plan had proposed to pay the $4000 claim plus 9.5% interest through $740 monthly payments over three years. Pet. 3. Respondent argued that the proper discount rate was 21%, because that was the interest rate charged under

[2] See 11 U.S.C. 1129(a)(7) (impaired classes of claims); 11 U.S.C. 1129(a)(9)(B)(i) and (C) (certain priority claims); 11 U.S.C. 1129(b)(2)(B)(i) and (C)(i) (unsecured claims and classes of interests); 11 U.S.C. 1225(a)(4) and (b)(1)(A) (unsecured claims); 11 U.S.C. 1228(b)(2) (discharge); 11 U.S.C. 1325(a)(4) and (b)(1)(A) (unsecured claims); 11 U.S.C. 1328(b)(2) (discharge).

petitioners' pre-bankruptcy loan and under other used car loans made by respondent. According to respondent, the plan was required to provide a 21% discount rate because, if respondent could have taken possession of the collateral, it could have funded another car loan at that rate. Pet. App. 5a.

Petitioners offered expert economic testimony indicating that the fair market price of capital and the time value of money was captured by a market "prime rate" of 8% interest, and that a 1.5% risk premium should be added to cover the risk that petitioners would not make payments as required by the plan. Pet. App. 65a-66a. Respondent offered evidence that its subprime used car loans typically carry a 21% interest rate, and that many Chapter 13 debtors fail to fulfill their plan obligations. *Id.* at 67a-74a.

The bankruptcy court rejected respondent's reliance on its own contract rates in calculating discount rates under Section 1325(a)(5). Instead, the bankruptcy court held that a 9.5% discount rate was sufficient to cover the fair market value of capital and the specific risks of nonpayment in this case. Pet. App. 43a. Respondent appealed to the United States District Court for the Southern District of Indiana. The district court reversed and held that the discount rate should be 21%, because that would have been respondent's contractual interest rate if it had sold the collateral to fund another subprime used car loan. See *id.* at 6a.

3. A divided panel of the court of appeals vacated the decision and remanded the case to the district court. The majority interpreted Section 1325(a)(5) as awarding a secured creditor "the 'indubitable equivalen[t]' of its property interest," and as requiring a discount rate to make the creditor "as well off in the reorganization as if it had been allowed to foreclose on and sell the [col-

lateral]." Pet. App. 17a-18a (internal quotation marks omitted). The majority held that a debtor's pre-bankruptcy contract rate is the presumptive minimum that serves those goals. Although it acknowledged that continuing "the old contract rate * * * under the supervision of the bankruptcy court will involve some risks that would not be incurred in a new loan * * * and also [will] result in some economies," *id.* at 20a, the majority opined that a presumption in favor of the pre-bankruptcy contract rate "will, in most cases, provide the best approximation of the proper [discount] rate," *id.* at 21a.

In dissent, Judge Rovner emphasized that compelling debtors to pay secured creditors based on "eye-popping" pre-bankruptcy contractual interest rates, such as respondent's 21% car loan, would reduce the feasibility of Chapter 13 plans and would diminish the likelihood of unsecured creditors' receiving any compensation. Pet. App. 22a. Judge Rovner noted that the courts of appeals have adopted different methods for calculating discount rates, including "the rate at which the creditor could borrow money to replace the collateral that the debtor has chosen to keep (the 'cost of funds' approach), the prime rate or a U.S. Treasury rate adjusted upward for the risk of nonpayment (the 'formula' approach), [and] the rate at which the creditor would make the same type of loan to someone like the debtor (the 'coerced loan' approach)." *Id.* at 24a.

Judge Rovner rejected the "coerced loan" or contract-rate approach adopted by the majority because it ignored the costs of disposing of the assets and of marketing and funding a new loan. Pet. App. 25a ("Requiring the debtor to pay the creditor the same rate of interest that the creditor would charge on a new loan to another consumer * * * over-compensates the

creditor, because it fails to account for the costs that the creditor would incur in funding the new loan."). Rather, Judge Rovner recognized, "[i]n this respect, the costs of funds approach comes closer to recognizing the economic consequences of the debtor's decision to keep the collateral." *Id.* at 26a. In the end, Judge Rovner concluded that Section 1325(a)(5) prescribes a formula-based discount rate that includes inflation, real interest rates, and a risk premium tailored to the plan's probability of nonpayment. See *id.* at 27a-28a ("[A] formulaic approach that employs as a base rate of interest an easily referenced rate like the prime rate or the rate on U.S. Treasury instruments, and which allows for modest enhancements to the base to account for the risk of nonpayment, is superior."). The exact amount of the plan-specific risk premium, Judge Rovner emphasized, presents "a question wisely left to the bankruptcy court, which is better situated to assess the risk of nonpayment and may adjust the rate accordingly." *Id.* at 28a.

SUMMARY OF ARGUMENT

In *Associates Commercial Corp.* v. *Rash*, 520 U.S. 953 (1997), this Court determined the proper method for ascertaining the value of collateral retained by the debtor and noted that in such circumstances, "the debtor is required to provide the creditor with payments, over the life of the plan, that will total the present value of the secured claim, *i.e.*, the present value of the collateral." *Id.* at 957 (citing 11 U.S.C. 1325(a)(5)(B)(ii)). To determine the "present value" of the payments envisioned by the plan, the bankruptcy court must employ a discount rate to reflect the time value of money. The narrow question in this case is what is the appropriate discount rate in such cases.

The Bankruptcy Code does not specify a discount rate, but the text of Section 1325(a)(5) and considerations of bankruptcy policy support the use of a discount rate that treats all creditors equitably and reflects real interest rates and inflation, rather than a presumption in favor of the pre-bankruptcy contract rate of interest, which may vary widely from creditor to creditor.

One appropriate method to calculate such a discount rate is to adjust low-risk interest rates, such as the prime rate, to account for plan-specific risks of nonpayment. That "prime-plus" formula approach determines the present value of a debtor's future payments based on the price of such payments in general financial markets, where the prime rate measures the value of low-risk capital. By including an adjustment for plan-specific default risks, a "prime-plus" formula provides a direct, fair market appraisal of the risk-adjusted present value of future payments. Such a formula approach is readily administrable; treats all creditors equally—thereby avoiding unfair disparities in cases where, as here, multiple secured creditors are parties to a single bankruptcy proceeding; and avoids the need for expert testimony regarding individual creditors' lending practices or credit status. See Pet. App. 78a.

In contrast, the "contract-rate" approach used by the court of appeals would require courts presumptively to value identical plan payments differently if those payments are made to creditors with different pre-bankruptcy contract rates. Such presumptions could be rebutted only by evidence of a specific creditor's current investment opportunities, but such opportunities are often difficult for courts to evaluate and are not directly relevant to the debtor's financial status. Furthermore, burdening debtors with often "eye-popping" contract rates, Pet. App. 22a, would under-

mine debtors' ability to pursue bankruptcy under Chapter 13, and would force many cases into liquidation under Chapter 7, to the general detriment of debtors and creditors alike.

The text of Section 1325(a)(5) supports a prime-plus formula, rather than a contract-rate, approach because it directs courts to determine the value of a debtor's proposed payments, not profits a creditor could hypothetically earn if it were allowed to liquidate and reinvest the collateral. Under this Court's decision in *Rash*, the value of a secured asset in a Chapter 13 cram down turns on the asset's actual value *to the debtor*, not its counterfactual foreclosure value *to the creditor*. See 520 U.S. at 962. Likewise, under Section 1325(a)(5), the value of plan payments depends on their estimated worth in financial markets, not on each creditor's revenues after a counterfactual foreclosure and new loan.

Standard discount rate calculations for future cash payments rest on the general time value of money and risks of nonpayment by the debtor. The court of appeals erred because it looked exclusively to the creditor's alleged opportunity costs, using evidence of respondent's subprime car loans. Because subprime car loans, like high-yield "junk bonds," are priced to include significant risk premiums, and may also include costs of marketing new loans and substantial profit margins, the prime rate is a better estimate of the time value of money and is thus a more reliable starting point for calculating a fair discount rate.

The court of appeals also erred by ignoring the bankruptcy court's case-specific determination, based on an examination of petitioners' financial status and expert testimony, that the plan's nonpayment risks required a 1.5% adjustment above the prime rate. That risk assessment is not disputed in this case, and it incor-

porates statutory safeguards that ensure that plan payments are made, including a bankruptcy court's duty to assess the plan's feasibility (11 U.S.C. 1325(a)(6)), the trustee's responsibility to advise and oversee administration of the estate (11 U.S.C. 1302 and 1326(a)(2)), limitations on the debtor's ability to incur new credit obligations (11 U.S.C. 1305(c)), and the court's authority to order payments directly from the debtor's income (11 U.S.C. 1325(c)). Such judicial oversight may often yield greater creditor protection than subprime loans in ordinary commercial markets.

ARGUMENT

THE APPROPRIATE DISCOUNT RATE IN ASSESSING THE VALUE OF PAYMENTS UNDER A PLAN SHOULD PRIMARILY REFLECT THE TIME VALUE OF MONEY, NOT THE PARTICULAR CREDITORS' PROFITS UNDER PRE-BANKRUPTCY CONTRACTS

Chapter 13's "cram down" provision states that where a secured creditor objects to the debtor's proposed plan, the debtor may choose to surrender the collateral securing the claim or may retain such collateral if the value of the stream of payments envisioned by the plan is "not less than the allowed amount of [the secured] claim." 11 U.S.C. 1325(a)(5)(B)(ii). This Court stated in *Rash* that in assessing the value of the payments under the plan to ensure that they equal or exceed the value of collateral, courts must evaluate the "present value" of the payments "over the life of the plan." 520 U.S. at 957. This case concerns the proper discount rate that courts should employ in making that present value calculation.

Although the Bankruptcy Code does not explicitly address how to select the appropriate discount rate, this Court in *Rash* appeared to focus on ensuring that

the present value was discounted by the time value of money so as to reflect the value of payments made "over the life of the plan." 520 U.S. at 962.[3] That focus on adjusting for the time value of money is consistent with the legislative history of Section 1325(a)(5) and similar present value provisions. See H.R. Rep. No. 595, *supra*, at 413 (recognizing that identical language in Chapter 11's cram down provision is intended to recognize the "time-value of money"); cf. *Chesapeake & Ohio Ry.* v. *Kelly*, 241 U.S. 485, 491 (1916) ("in computing the damages recoverable for the deprivation of future benefits, the principle of limiting the recovery to compensation requires that adequate allowance be made, according to circumstances, for the earning power of money"). At a minimum, therefore, the appropriate discount rate must reflect the real interest rate and account for inflation.[4]

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[3] That the Court in *Rash* viewed "present value" as simply rejecting an adjustment for the time value of money is reinforced by the Court's description of the original proposed plan in that case as providing for payments, "over 58 months," in "an amount equal to the present value of the truck." 520 U.S. at 957. The total proposed payments in that case reflected principal in the amount of the alleged value of the truck, plus interest at nine percent. See *In re Rash*, 31 F.3d 325, 327 (5th Cir. 1994).

[4] The text of Section 1325 is consistent with the view that the appropriate discount rate should reflect only the time value of money and not any risk premium. Section 1325(a)(5) does not specify the discount rate that should be employed in assessing the value of a stream of payments or whether a separate adjustment for risk should be made. That silence may be consistent with a view that the "value" determination mandated by Section 1325(a)(5) (and Section 1325(a)(4)) requires only a mechanical adjustment for the time value of money, rather than a more complicated adjustment for risk. Likewise, Section 1325(a)(6) requires the bankruptcy court to verify that "the debtor will be

In addition, some courts of appeals have included an adjustment for the risk of extending credit based on the bankruptcy court's assessment of the debtor's financial condition. This approach builds on an interest rate, like the prime rate, that reflects real interest, inflation, and some risk premium, and then adjusts it for the case-specific risks of default. It reflects the recognition that, although the bankruptcy court has determined that "the debtor will be able to make all payments under the plan" as a condition of plan confirmation, 11 U.S.C. 1325(a)(6), there is still a practical risk that the debtor will default on its payments. One of the virtues of this approach is that it focuses the court's discretion on an issue—the case-specific risk of nonpayment—that the bankruptcy court is uniquely competent to make.[5]

Other courts, however, have held that the discount rate is presumptively equal to the pre-bankruptcy contract's interest rate. Such a "contract-rate" approach misconstrues the language and function of

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able to make all payments under the plan and comply with the plan." Such a determination would be consistent with an assessment of value that reflected the time value of money, but not the risk that "the debtor will [*not*] be able to make all payments under the plan." This preference for a mechanical adjustment for the time value of money rather than a complicated adjustment would also be consistent with this Court's warning in another context that disputes over the proper discount rate should not convert "[t]he average accident trial * * * into a graduate seminar on economic forecasting." *Jones & Laughlin Steel Corp.* v. *Pfeifer*, 462 U.S. 523, 548 (1983) (citation omitted).

[5] Some support for this approach may be found in this Court's observation in *Rash* that one reason for adopting the replacement value as the measure of the collateral was that "[a]djustments in the interest rate" may not be enough to account for case-specific risks of nonpayment and depreciation of collateral. 520 U.S. at 962-963.

Section 1325(a)(5), creates disparities among creditors, and imposes undue administrative burdens on bankruptcy litigation.

A. The Court Of Appeals' Contract-Rate Approach Is Inconsistent With The Text And Purposes Of Section 1325(a)(5), Especially As Interpreted By This Court In *Rash*

The court of appeals declared that bankruptcy courts should, absent contrary evidence, accept a creditor's pre-bankruptcy contract rate as proof of counterfactual profits that it would have earned had it foreclosed and used the proceeds to fund a new loan. See Pet. App. 17a-22a. Such an approach is inconsistent with the text and purposes of the Bankruptcy Code. As an initial matter, Congress, in 11 U.S.C. 1322, has generally authorized the wholesale modification of the contractual rights of all creditors, including by permitting courts to "modify the rights of holders of secured claims." 11 U.S.C. 1322(b)(2). With the exception of home mortgages, which Congress expressly exempted from modification in most cases, see 11 U.S.C. 1322(b)(2) and (c)(2), the authority to modify contractual rights includes the power to alter contractual interest rates. See 1 Keith M. Lundin, *Chapter 13 Bankruptcy* § 104.1, at 104-1 (3d ed. 2002) (Section 1322(b)(2) grants courts the "very significant power * * * to change contract terms by altering interest rates and monthly payments, by changing the length of the repayment period, by changing the total amount to be repaid and by modifying acceleration and default provisions.").

The scope of the Chapter 13 authority to modify contractual rights is evidenced in this case. Virtually every term of respondent's loan was modified under the repayment plan—from the amount to be repaid to the

length of the repayment period—and respondent has not challenged those modifications. As the exemption for home mortgages contained in Section 1322(b)(2) demonstrates, if Congress had wanted to exempt contractual interest rates from modification under Chapter 13 repayment plans, it knew how to do so.

Instead, Congress, in Section 1325(a)(5), without specifying any particular discount rate or even outlining a methodology for determining a discount rate, merely provided that "the value, as of the effective date of the plan, of property to be distributed under the plan on account of [an allowed secured claim]" should be "not less than the allowed amount of such claim." 11 U.S.C. 1325(a)(5)(B)(ii). Nothing in that language suggests that in a cram down proceeding the present value of the stream of payments envisioned by the plan should turn on the pre-bankruptcy interest rate specified in a superseded contract or by the hypothetical profits that the creditor could have earned if it could have foreclosed on the collateral and funded a new loan.[6]

This Court rejected similar creditor-specific valuation methods in *Rash*. There, the question was how to value a secured claim for purposes of Chapter 13's cram down provision. See 11 U.S.C. 506(a). The court of appeals had held that the value of a secured claim's collateral should be equal to the collateral's "foreclosure value"—*i.e.*, what the particular creditor would have earned if it had repossessed and liquidated the collateral. This Court disagreed, refusing to determine the collateral's value based on creditor-specific opportunity costs where the debtor, not the creditor, retains the collateral. Instead, the Court employed a "replacement value" standard based on normal market prices and the collateral's actual value to the debtor. The Court explained that a secured asset's value turns on "the creditor's interest in the collateral in light of the proposed [repayment plan] reality: no foreclosure sale * * *. That actual use, rather than a foreclosure sale that will not take place, is the proper guide." 520 U.S. at 963 (internal quotation marks and citations omitted).

That the replacement value of the collateral may generally provide the secured creditor with more than it would have received had it foreclosed on the collateral and reinvested the proceeds is of no moment, the Court explained, because Chapter 13 expressly ties the value of the creditor's claim to the "proposed disposition or use" of the collateral. 520 U.S. at 962 (quoting 11 U.S.C. 506(a)). Accordingly, the value of the creditor's claim "turns on the alternative the debtor chooses —in one case the collateral will be surrendered to the creditor, and in the other, the collateral will be retained and used by the debtor." *Ibid.* Thus, the Court concluded, the text of the Bankruptcy Code governing Chapter 13 requires that "[f]rom the creditor's perspective as well as the debtor's, surrender and retention [of collateral] are not equivalent acts." *Ibid.*

By analogy, in determining the present value of a debtor's plan payments, the income that a specific creditor could have earned under the contract in the absence of Chapter 13 proceedings or in the counterfactual event that the proceeds of a foreclosure sale were available for reinvestment is beside the point. The statutory task is to appraise the value of the plan's

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[6] That Section 1325(a)(5) does not support the contract-rate approach adopted below is further evidenced by the fact that Congress has rejected attempts to amend Section 1325 to require that approach. See H.R. 1085, 98th Cong., 1st Sess. § 19(2)(A) (1983); H.R. 1169, 98th Cong., 1st Sess. § 19(2)(A) (1983); H.R. 4786, 97th Cong., 1st Sess. § 19(2)(A) (1981).

future payments, and that appraisal—like the valuation of the underlying claim that was at issue in *Rash*—need not be contingent on what a particular creditor might have done if it had been allowed to liquidate the collateral.[7]

The court of appeals reached a contrary conclusion because it misconstrued the structure of Section 1325. Where a secured creditor objects to a repayment plan,

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[7] One notable difference between *Rash* and this case is that—unlike the market for automobiles that provided the basis for the replacement-value calculation in *Rash*—there is no directly analogous "market" for discount rates that reflects the unique mix of transaction costs, risks, and protections that exist in bankruptcy. As one court explained, "it is difficult to arrive at a current market rate of interest for a hypothetical new loan when there is no market for the loan proposed, no equity in the property and limited opportunity on the part of the debtor to obtain financing outside of the Bankruptcy Code framework." *In re Jordan*, 130 B.R. 185, 189 (Bankr. D.N.J. 1991), overruled by *GMAC* v. *Jones*, 999 F.2d 63 (3d Cir. 1993); see *In re Ivey*, 147 B.R. 109, 118 (M.D.N.C. 1992) (describing attempts to determine the precise rate on a hypothetical loan as "impossible and simply a waste of time") (citation omitted); *In re Computer Optics, Inc.*, 126 B.R. 664, 672 (Bankr. D.N.H. 1991) (noting that any rate arrived at by comparison to a hypothetical market would be highly speculative). Particularly given the absence of any directly analogous market, the prime-plus approach represents the most equitable, accurate, and efficient method for determining Chapter 13 cram down discount rates. Moreover, any suggestion that the replacement value concept supports adoption of subprime rates in this context because no lender in any hypothetical market would make a loan to a Chapter 13 debtor for less than such a near usurious rate would be misguided. Even if the assumption underlying that argument were true (which is questionable), it would not support adopting a presumption in favor of the pre-bankruptcy contract rate (which may or may not be a subprime rate), although it may suggest that the risk factor element under a prime-plus approach may need to be larger than some courts have suggested.

Section 1325 nonetheless allows approval of the plan if the debtor surrenders the collateral, or if the present value over the life of the plan of the payments envisioned by the plan is no less than the value of the collateral. The court of appeals—like a number of courts of appeals that adopted the "contract-rate" or "coerced loan" approach prior to this Court's decision in *Rash*—erred by assuming that "Congress intended that each of these options [*i.e.*, foreclosure or cram down] afford the secured [creditor] somewhat equivalent protection," Pet. App. 11a, and by inferring an unstated "statutory directive that the creditor be placed in the same position as * * * if it had been allowed to * * * repossess[] the collateral," *id.* at 19a. Cf. *GMAC* v. *Jones*, 999 F.2d 63, 68 (3d Cir. 1993) (stating goal of discount rate calculation as placing creditor "in approximately the same position it would have occupied had it been able simply to repossess the collateral at the time of the bankruptcy"); *United Carolina Bank* v. *Hall*, 993 F.2d 1126, 1130 (4th Cir. 1993) (indicating purpose of discount rate calculation "is to place the secured creditor in the same economic position as if the debtor had surrendered the collateral to the secured creditor").[8]

After *Rash*, however, it is clear that the Code does not ensure parity between what a creditor receives in foreclosure and what a creditor receives when the debtor retains the collateral. If a debtor surrenders the

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[8] Indeed, of the court of appeals decisions to adopt the contract-rate approach, only this case and the Fifth Circuit's decision in *In re Smithwick*, 121 F.3d 211, 213-215 (1997), cert. denied, 523 U.S. 1074 (1998), were decided after this Court's ruling in *Rash*, and both of those decisions rely on pre-*Rash* cases with little or no discussion of *Rash*'s impact.

collateral, the creditor effectively obtains the asset's "foreclosure value," and that foreclosure value constitutes a creditor's opportunity cost under a Section 1325(a)(5) cram down. If the debtor retains the collateral and invokes the cram down provision, however, the creditor receives a bankruptcy claim equal to the asset's "replacement value" in the marketplace, which often may be significantly larger than the creditor-specific foreclosure value. See *Rash*, 520 U.S. at 957-960. Just as Congress did not ensure a consistent value for the collateral without regard to whether the debtor retained the property, it did not prescribe that creditors should earn equal rates of return through foreclosure and plan payments under 11 U.S.C. 1325(a)(5). In both contexts, the Bankruptcy Code gives the option to the debtor and focuses on the actual value of the asset in light of the debtor's choice, not on its value if the debtor had made the opposite choice.[9]

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[9] The court of appeals also indicated that Section 1325(a)(5) entitled a secured creditor to the "'indubitable equivalence' of its property interest, which means a stream of payments including interest that adds up to the present value of its claim." Pet. App. 17a (citation omitted). The statutory term "indubitable equivalent," however, appears only in two provisions of the Bankruptcy Code, neither of which applies here. See 11 U.S.C. 361(3) (dealing with automatic stay and trustees' authority to sell estate property or obtain credit); 11 U.S.C. 1129(b)(2)(A)(iii) (prescribing an "indubitable equivalent" standard as an alternative to cram down in Chapter 11 proceedings). Moreover, even if secured creditors did deserve an "indubitable equivalence" under Chapter 13, it would be only an equivalence between the plan's proposed payments and *the creditor's allowed secured claim*. Disputes over present value and discount rates concern how courts should calculate that equivalence. Language quoted from Sections 361(3) and 1129(b)(2)(A)(i) does not in any way answer that question.

B. The Prime-Plus Formula Approach, Unlike The Contract-Rate Approach, Comports With The Bankruptcy Code's Fundamental Goal Of Treating Similar Classes Of Creditors Equally

1. A prime-plus formula is appropriate for calculating discount rates in bankruptcy proceedings because it treats all secured creditors equally based on the value of their claims. See *Begier* v. *IRS*, 496 U.S. 53, 58 (1990) ("Equality of distribution among creditors is a central policy of the Bankruptcy Code."); see also *Union Bank* v. *Wolas*, 502 U.S. 151, 161 (1991) (describing "equality of distribution among creditors" as "the prime bankruptcy policy"). Under a prime-plus formula, two secured creditors with the same payment streams for collateral of equal value would be subject to the same discount rate and necessarily would receive comparable treatment under the plan. Under a contract-rate approach, however, the same two creditors might be subject to widely different discount rates even though they would confront equal plan-specific default risks and equal costs due to the time value of money, simply because their contract rates reflect contracts created at different times, under different inflation rates, or when the debtor occupied a different financial position. Such anomalies only increase for secured creditors that change their lending rate or line of business or that sell their claims to other entities. Cf. *United Carolina Bank* v. *Hall*, 993 F.2d 1126, 1131 (4th Cir. 1993) (holding that discount rates change when secured claims are purchased by an entity with business opportunities different from the original claimholder's).[10]

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[10] Although no court of appeals has yet addressed the issue, the logic of the court of appeals' contract-rate approach would apply

Nothing in the Bankruptcy Code suggests that such a contract-specific and creditor-specific approach is either required or appropriate, and the costs associated with such a standard are substantial. Such creditor-specific approaches to determining discount rates "are nightmares of logic and application." 2 Keith M. Lundin, *Chapter 13 Bankruptcy* § 112.1, at 112-8 (3d ed. 2002); see *ibid.* ("If present value varies from creditor to creditor depending on facts specific to each creditor's financial condition, management and lending practices, then the interest rate at confirmation in a Chapter 13 case will be different with respect to every claim. * * * It is not imaginable that Congress intended 'value, as of the effective date of the plan' to mean that inefficient, poorly managed lenders get higher interest rates than well managed, better capitalized lenders.").[11]

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equally to unsecured creditors as well. Under 11 U.S.C. 1325(a)(4), for example, Congress used language identical to Section 1325(a)(5) in requiring that unsecured creditors receive a "value, as of the effective date of the plan, of property to be distributed under the plan" at least equal to what they would receive through liquidation under Chapter 7. Similar provisions also exist under Chapters 11 and 12. See 11 U.S.C. 1129(a)(7)(A)(ii), 1225(a)(4). Thus, the principles underlying the contract-rate method imply that *every* creditor in proceedings under Chapters 11, 12, or 13 could demand a discount rate specific to its opportunity costs for payments provided to it under a single debtor's plan, and those discount rates would presumptively depend on the interest rate in pre-bankruptcy contracts. See 8 *Collier on Bankruptcy* ¶ 1325.06[3][b], at 1325-36 (Alan N. Resnick & Henry J. Sommer, eds., 15th ed. rev. 2003).

[11] The Third Circuit in *GMAC* v. *Jones*, 999 F.2d at 70 n.10, sought to bolster its contract-rate analysis by citing the legislative history of 11 U.S.C. 502(b). Section 502(b)(2), however, merely states that claims for unmatured principal are allowed in bankruptcy, while claims for unmatured interest are disallowed. It has nothing to do with present value calculations under Section 1325,

The principle that a particular creditor's high pre-bankruptcy contractual interest rate should not be allowed to absorb a debtor's estate to the detriment of other similarly situated creditors has long been a part of bankruptcy law. Before the 1984 amendments to the Bankruptcy Code codified the disallowance of claims for unmatured interest, see 11 U.S.C. 502(b)(2), this Court had long disallowed such claims, in significant part to avoid the "unfairness as between competing creditors" resulting from the fact that some creditors "carry a

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as a careful reading of the House Report in question makes clear. The Report notes that the Code disallows as unmatured a claim for "any portion of prepaid interest [under a contract] that represents an original discounting of the claim, yet that would not have been earned on the date of bankruptcy," and it states that an "unarticulated reason" for that result is that there is an "irrebutable presumption that the discounting rate and the contractual interest rate * * * are equivalent." H.R. Rep. No. 595, *supra*, at 352, 353. In essence, it observes (albeit somewhat confusingly) that Section 502's disallowance of unmatured interest, at least in the narrow context of an original discount of interest provided for by a contract, is mathematically equivalent to a hypothetical statute that allowed such interest but discounted it using the contractual interest rate. Nothing in that language should be read as propounding a general methodology for determining present value. See *Dunn* v. *CFTC*, 519 U.S. 465, 478 (1997) (describing similar statements as "legislative dicta"). That is particularly true given that the legislative history of the Bankruptcy Code provisions that do concern present value calculations indicates that there is no automatic or universal presumption that contractual interest rates and discount rates are equal. See, *e.g.*, H.R. Rep. No. 595, *supra*, at 414-415 (describing present value calculation under Chapter 11's cram down provision without reference to the pre-bankruptcy contract rate). Moreover, neither the Third Circuit nor any other circuit has adopted an "irrebutable presumption" favoring the contract rate, as its misguided reliance on Section 502(b)'s legislative history would suggest. *E.g.*, *Jones*, 999 F.2d at 70-71. Nor has respondent advocated such a mechanical rule. Br. in Opp. 4.

high [interest] rate and some a low [interest] rate." *Bruning* v. *United States*, 376 U.S. 358, 362 & n.4 (1964) (quoting *American Iron & Steel Mfg. Co.* v. *Seaboard Air Line Ry.*, 233 U.S. 261, 266 (1914)); see *Nicholas* v. *United States*, 384 U.S. 678, 683-84 (1966) ("inequity * * * would result if, through the continuing accumulation of interest * * * [during] bankruptcy proceedings, obligations bearing relatively high rates of interest were permitted to absorb the assets of a bankrupt estate whose funds were already inadequate to pay the principal of the debts owed by the estate"). Although the question of the proper discount rate under Section 1325(a)(5) is distinct, those same equitable considerations counsel strongly against a creditor-specific contract-rate approach.

In addition, by requiring courts to compare the value of a creditor's hypothetical investments based on the counterfactual assumption that the creditor foreclosed on the collateral and used the proceeds to fund a new loan, the contract-rate approach would result in substantial and needless administrative difficulties. In contrast, a prime-plus formula provides a broadly applicable method of calculating discount rates that is administrable in bankruptcy proceedings, where litigation costs can be significant, because it turns on readily available market data and risks of plan nonpayment that bankruptcy courts are inherently well-situated to assess. See 11 U.S.C. 1325(a)(6).

2. As the foregoing suggests, simply reconceptualizing Section 1325(a)(5)'s cram down provision as a "coerced loan" (Pet. App. 17a), is misguided, and in any event, does not answer how a court should determine the discount rate. In the first place, viewing the cram down provision as a coerced loan is based on the counterfactual assumption that the creditor is, or

should be, in the same position as if the collateral had been liquidated and a new loan initiated. But *Rash* rejects any notion that the Code guarantees the creditor the same rights when the debtor retains the property as when the collateral is liquidated.

The court of appeals' decision is also flawed because, even if respondent had liquidated the collateral to issue another subprime car loan, the 21% contract rate of that hypothetical loan would have to be adjusted, for purposes of Section 1325(a)(5), to account for potentially significant differences in the creditor's costs and the debtor's risk of default. Unlike its other subprime loans, the so-called "coerced loan" respondent extended to petitioner under the repayment plan did not require respondent to incur traditional marketing and other transaction costs that are reflected in its subprime rate. As a leading bankruptcy treatise explains, "[t]o include [such costs] in the present value discount rate gives the holder of an allowed secured claim more than the equivalent of immediate payment of that claim in full." 8 *Collier on Bankruptcy* ¶ 1325.06[3][b], at 1325-36 (Alan N. Resnick & Henry J. Sommer, eds., 15th ed. rev. 2003); see *id.* at 1325-35 to 1325-36 (concluding that "it is rarely appropriate to select the rate charged to the debtor in the original transaction as the present value discount rate"); see Pet. App. 29a-30a.

In any event, the coerced loan analogy does not dictate a particular discount rate. Indeed, the court of appeals acknowledged as much in its discussion of *Koopmans* v. *Farm Credit Services of Mid-America, ACA*, 102 F.3d 874 (7th Cir. 1996). See Pet. App. 19a ("It is clear that *Koopmans* * * * adopted the coerced loan method, *the specific application of which led to the prime-plus rate.*") (emphasis added); cf. *id.* at 31a-32a (noting *Koopmans* "endorses the coerced loan ap-

proach," but "affirm[ed] the bankruptcy court's decision to use the prime rate with an appropriate risk enhancement"); *In re Kidd*, 315 F.3d 671, 672, 675-678 (6th Cir. 2003) (adopting "coerced loan" formulation, but rejecting an "automatic" preference for either the contract rate or a hypothetical rate "that would apply in the nonexistent 'market' that encompasses the factors prevalent in the bankruptcy setting," and instead affirming the district court's adoption of a "conventional" car loan rate of 10.3%). A prime-plus formula reflects the discount rate appropriate at the time of the so-called "coerced loan" based on the bankruptcy court's assessment of the risks of default, while a contract-rate approach would presumptively set the discount rate based on an interest rate agreed to at a different time under starkly different circumstances. The peculiarity of the contract-rate approach is that different levels of compensation are prescribed for different secured creditors, even if they make identical "coerced loans" to the same debtor, with identical risks of default.

The "coerced loan" metaphor also overlooks the fact that other creditors' interests are often affected in ongoing bankruptcy proceedings. For typical cases, where assets are scarce, to favor the interests of one secured creditor implicitly disfavors the interests of other creditors. For unsecured creditors especially, the contract-rate approach would result in fewer assets for the payment of claims, because it significantly increases payments for high-interest secured creditors.

3. To require full satisfaction of pre-bankruptcy contracts under Chapter 13 repayment plans—even where contractual rates far exceed the risk-adjusted market value of capital—would hinder courts' ability to confirm Chapter 13 plans and debtors' ability to complete their payments under those plans. Pet. App. 22a;

H.R. Rep. No. 595, *supra*, at 117. The burdens of the contract-rate approach thus fall on debtors and creditors alike, because where Chapter 13 bankruptcy proceedings fail, debtors may be forced to enter liquidation-based bankruptcy under Chapter 7.

In enacting the Bankruptcy Reform Act of 1978, Congress made clear its preference for the flexible provisions of Chapter 13 bankruptcy relative to Chapter 7 liquidation. Chapter 13 debtors benefit by retaining possession of their assets, and Chapter 13 creditors benefit because they may seek compensation from a creditor's income, such that in most cases "losses will be significantly less" than under Chapter 7. H.R. Rep. No. 595, *supra*, at 118 ("[U]se of the bankruptcy law should be a last resort [and] if it is used, debtors should attempt repayment under Chapter 13."); *id.* at 124. Congress did not express this preference for Chapter 13 proceedings and give bankruptcy judges the power to override contract terms, including interest rates, only to saddle debtors emerging from Chapter 13 with high contract rates of interest that may force debtors into a Chapter 7 liquidation. Instead, consistent with the Bankruptcy Code's safeguards for both debtors and creditors, Section 1325(a)(5) is properly read to calculate discount rates using a prime-plus formula, which primarily focuses on the time value of money, grants secured creditors no more than a risk-adjusted market interest rate, and treats all secured creditors equally.

C. The Court Of Appeals' Reasons For Rejecting The Prime-Plus Formula Are Unpersuasive

The court of appeals rejected the bankruptcy court's prime-plus approach on the grounds that it inadequately protected respondent from (1) risks that petitioners might default under the plan, (2) risks that

the collateral would depreciate, and (3) costs of maintaining the loan. Pet. App. 16a. Each of those concerns is misplaced.

First, with respect to default, the court of appeals overlooked the fact that the bankruptcy court must verify that the plan payments "will" in fact be made before approving the plan. 11 U.S.C. 1325(a)(6); see n.4, *supra*. While many Chapter 13 plans do fail, a concern for the risk of default is properly reflected in subsection (a)(6), and to the extent that concern for default prompts courts to apply "eye-popping" contract-based discount rates under subsection (a)(5), the concern may become a self-fulfilling prophecy.

The court of appeals' concern also overlooks the fact that the prime-plus approach explicitly adjusts the discount rate to account for nonpayment risks under the plan and that bankruptcy courts are particularly well-positioned to evaluate such nonpayment risks. Here, the bankruptcy court examined petitioners' financial status and expert economic testimony and concluded that the plan-specific risk of nonpayment required a 1.5% adjustment above the prime rate. That risk assessment is undisputed as a factual finding.[12]

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[12] The bankruptcy courts should presumably have substantial flexibility in making a risk adjustment when the extent of the adjustment is disputed. Cf. *Rash*, 520 U.S. at 965 n.6 (noting bankruptcy courts' flexibility in administering Chapter 13 proceedings). That is the approach this Court has taken in other contexts involving present value calculations. See, *e.g.*, *Jones & Laughlin Steel*, 462 U.S. at 546 (declining to adopt "one of the many rules that have been proposed and establish it for all time as the exclusive method in all federal trials for calculating an award for lost earnings in an inflationary economy"). In some cases, a debtor's risk of nonpayment could be substantial. On the other hand, at least one commentator has opined that the risk-factor element under the prime-plus approach "need not be large," because "the creditor's

In addition to the bankruptcy court's feasability determination under Section 1325(a)(6), Chapter 13 contains a number of other safeguards for creditors that are reflected in the bankruptcy court's risk assessment, including a requirement that the trustee advise and oversee administration of the estate (11 U.S.C. 1302 and 1326(a)(2)), restrictions on the debtor's ability to incur new credit obligations (11 U.S.C. 1305(c)), and the authority of the bankruptcy court to order payments to be deducted directly from the debtor's income (11 U.S.C. 1325(c)). While such oversight by bankruptcy courts and trustees may not eliminate the risk of nonpayment, it may often yield greater protection, at lower costs to creditors, than would be available for subprime loans in normal commercial markets.

Second, this Court considered in *Rash* the risks of depreciating collateral and observed, contrary to the court of appeals' reasoning, that Congress *expected* secured creditors to bear some of those costs. 520 U.S. at 962-963. In any event, the contract-rate method depends primarily on pre-bankruptcy contracts and current investment opportunities, rather than pegging discount rates to specific concerns about post-bankruptcy depreciation. Accordingly, under the contract-rate method, creditors with high contract rates presumptively would receive larger payments under a cram down than creditors with low contract rates, even

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main protections against risk" are those expressly provided for in the Bankruptcy Code and because subprime lending rates may be primarily the result of "high costs of marketing, high transaction costs relative to the amount of the debt, and consumers' failure to effectively shop for lower rates due to various imperfections in the market." 8 *Collier on Bankruptcy*, *supra*, ¶ 1325.06[3][b], at 1325-37.

if the latter's collateral suffered greater risk of post-bankruptcy depreciation.

Third, the court of appeals failed to explain, and the record does not indicate, any significant costs to respondent of "continuing to service the loan." Pet. App. 16a, 20a n.5. On the contrary, as the court of appeals acknowledged, a creditor may reap substantial administrative "economies" in bankruptcy as compared with ordinary commercial loans. *Id.* at 20a. For example, the bankruptcy court takes primary responsibility for evaluating the plan's initial feasibility (11 U.S.C. 1325(a)(6)), and the trustee—not the creditor—monitors, collects, and distributes plan payments, while also more generally endeavoring to protect the estate from abuse (11 U.S.C. 1302 and 1326(a)(2)). There is no indication that Congress sought to protect secured creditors from any residual costs that remain, much less that Congress implicitly did so by rendering discount rates under Section 1325(a)(5) equal to a creditor's pre-bankruptcy contract rates.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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